RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED
Since 1958
Post Office Box 1759, La Jolla, California 92038 17 Letters Per Year • $250 annually www.dowtheoryletters.com

January 31, 2001 **LETTER 1313**

January 12, DJIA 10522.90; PTI 5199; A-D Ratio –5.02
January 19, DJIA 10586.37; PTI 5213; A-D Ratio –4.82
January 26, DJIA 10659.98; PTI 5223; A-D Ratio –4.27
*Dow Times Book Value: +6.51
*Percentage of Undervalued Blue-chips: 15%
*Gold 34-day MA: 268 Dow yield: 1.64; Dow p/e: 21.5

THE DOW: I've said this many times, but I'll repeat it. The stock-buying public doesn't relate to the price of the Nasdaq or the S&P – what they do relate to is the price of the Dow.

The D-J Industrial Average is composed of thirty giant blue-chip stocks. They are "backbone of the economy" type stocks.

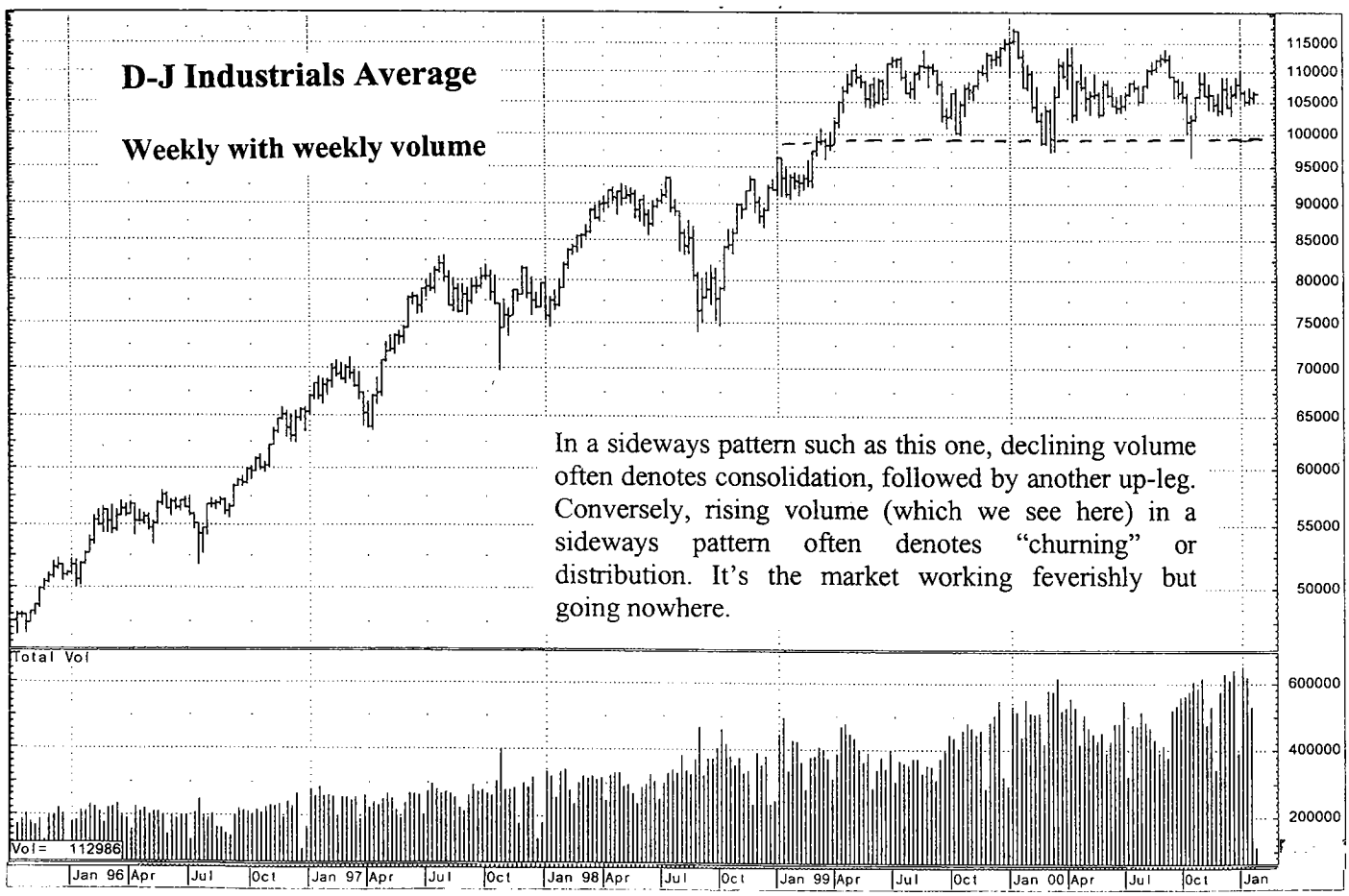
To give you an example of size, when Oldsmobile (division of GM) closed down, they laid off more workers than all the workers who have been laid off due to the collapse of the many dot-coms.

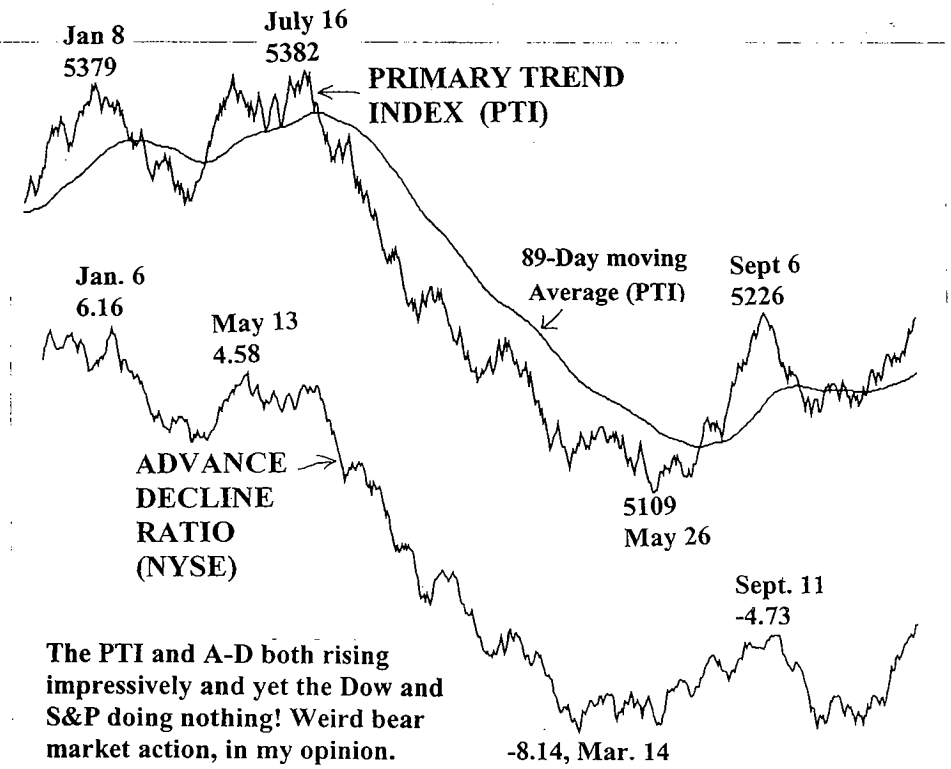
I've been following the action of the Dow for half a century. The pattern I see now is worth studying, and frankly I haven't seen anyone else drawing attention to it.

The chart on this page shows the Dow weekly from January 1996 to the present. The Dow rose strongly through 1995, 1996, and 1997. But beginning in April 1998 the Dow began to move in an extended sideways pattern.

But strangely, instead of volume simmering down as I would expect in a sideways movement -- volume on the NYSE started to expand. Starting in October 1999 and all through the year 2000 volume continued at a record-high rate.

So what we've been seeing over the last 15 months is record high volume with the Dow essentially going nowhere. This is not good action. It amounts to stocks "churning" on high volume. I equate it to rushing up the down-escalator. The rusher becomes increasingly overheated -- but all the while he's getting nowhere and going nowhere.


D-J Industrials Average
Weekly with weekly volume
In a sideways pattern such as this one, declining volume often denotes consolidation, followed by another up-leg. Conversely, rising volume (which we see here) in a sideways pattern often denotes "churning" or distribution. It's the market working feverishly but going nowhere.
Total Vol
Vol= 112986
115000
110000
105000
100000
95000
90000
85000
80000
75000
70000
65000
60000
55000
50000
600000
400000
200000
Jan 96 Apr Jul Oct Jan 97 Apr Jul Oct Jan 98 Apr Jul Oct Jan 99 Apr Jul Oct Jan 00 Apr Jul Oct Jan



The PTI and A-D both rising impressively and yet the Dow and S&P doing nothing! Weird bear market action, in my opinion.

It's important to realize that what we're seeing now are corrections in an ongoing bear market. These occur during all movements, whether bull or bear.

Even after the huge crash of 1929, the Dow corrected very powerfully into April of 1930. During that wildly speculative correction, the Dow recovered 52% of its 1929 crash losses.

In fact, the huge upward correction of 1930 was so explosive that most participants believed that a new bull market had started.

To return to the present, let's take the broad S&P 500 Composite. This is the average that most professionals monitor. The S&P topped out on March 24, 2000 at 1527.46. From there the S&P turned down, hitting a closing low of 1264.74 on December 20, 2000. That represented a total loss of 263 points.

Friday (Jan. 26) the S&P closed at a recovery high of 1357. At this price, the S&P **has recovered 34% of its March to December losses**. This is on the minor side of a normal correction. Historically, a correction will recover one-third to two thirds of the previous losses.

By the same token, the Nasdaq (Jan. 26. close) closed at 2779. This represents roughly 34% of its March to December losses, also a normal but not particularly impressive correction.

OVERVIEW – The latest issue of *New York* magazine (January 22) on its cover features "James J. Cramer's 2001 Investment Guide. 20 Great Stocks You Can't Live Without, and 10 Mutual Funds That Won't Let You Down."

I like Cramer, like Bill Clinton, he's everywhere -- in *Time Magazine*, in *New York Magazine*, in the *New York Observer*. Whenever I pick up a book or paper, I expect to see Cramer's name there. He's even on TV a la CNBC. He's everywhere. And I think he's smart. Well, obviously, he loves to write – and talk.

His article starts, "Quit moping about last year's market meltdown. That's ancient history. The time to get on with the rest of your investing life is right now. . . . Now that Greenspan has taken his foot off the break and begun to force interest rates down, you want exposure to the stock market . . . This is the lowest risk, highest reward environment possible. You have the Fed – and history – totally on your side."

The reason I mention Cramer is that I think this is the prevailing sentiment among most of the fund managers and probably a large segment of the "sophisticated" element in the stock market.

And it could be the correct sentiment. And then again it could not. Hey, who wants to fight the Fed?

I've said many times that I've learned to ignore Wall Street's gurus. I've said before that the more cocksure the advisor, the bigger the fool. Not that I think Cramer is a fool, but he is very cocksure. Most people need and want **certainty,** and that's what most investment advisors provide.

I distrust certainty where the stock market is concerned. I've said ad nauseum that the only "advisor" I trust is the market itself, and for new subscribers I'll repeat that statement. I trust the stock market, and that's all I trust in this business.

Nothing works to perfection where the stock market is concerned. Nothing is certain -- we're always dealing with probabilities.

When I first started in this business I read the greatest of all "readers of the averages," Robert Rhea. I studied Rhea for two years straight, I read his books, I followed his charts, I read his "Dow Theory Comment" reports until I had just about memorized everything Rhea ever wrote.

Later I did the same thing with the great Dow Theorist, E. George Schaefer. In fact, I often think to myself, "I wonder what Schaefer would have said in this situation."

Schaefer was an expert on two areas, **values** and the **primary trend** of the market. He ignored secondary corrections either up or down. He was only interested in the long-term trend. Traders, he thought, usually ended up by trading themselves into losses, or trading themselves out of the greatest part of the major moves.

Schaefer would make up his mind about the direction of the great primary trend of the market. If he was bullish, he loaded up with stocks and held those stocks through "thick and thin" and finally sold them when he thought the market was topping out.

If Schaefer thought the primary trend was down, he got out of the market, got into T-bills or some other very safe security – and he stayed out until the Dow Theory and values told him that the bear market had hit bottom.

I followed Schaefer's writing for years. I still have volumes of his writings. He was, like Robert Rhea, an authentic stock market genius. I've written a lot about both Rhea and Schaefer in the Dow Theory section on the home site, which I hope you've read or that you will read.

Although a general atmosphere of bullishness now prevails, I continue to underline two theses. (1) The Dow and the S&P, based on any historical measure, remain extremely overvalued. (2) The great primary trend of the market is down.

Historically, we know that when the price/earnings ratio for the major market averages is 22 or higher, the median return for stocks over the following ten years is 5.0%. When the P/E is 20 to 22 the median return is 5.7%.

This, of course, doesn't mean that the return was 5.0% or 5.7% each year of the ten years. It's the median, and this could include both bear markets and bull markets within those ten years.

The P/E on the widely-followed S&P Composite is now 25. This at least suggests that if you buy stocks at today's prices, you're going to have a rocky time holding those stocks over the next ten years. My bet is that you're not going to be able to hold them. You're going to get "knocked out of the box." You're better off buying a ten-year T-note, watching the market, and waiting for the bear market to bottom.

One item is particularly interesting here. It appears that the Fed has panicked. I look at the charts and statistics from the St. Louis Fed and I shake my head in disbelief. MZM (comparable to cash) is accelerating up at the latest rate of 12.9%. And Adjusted Reserves are zooming up at an incredible 16.7%. Over the past six weeks, the Fed has created over $160 billion in new money. Isn't the Fed afraid of bringing back the bubble? Maybe, but they're more afraid of a "hard landing" or maybe (worse) a recession.

What we're seeing now is a battle between declining corporate earnings vs. declining interest rates and an acellerating money supply. This has resulted in a fascinating and most important market battle – a battle in which **the Dow will either confirm, or refuse to confirm, the Transports**. Will the Dow succeed? Why guess? Let's just watch the show.

INVESTMENT POSITION: The bear is still king of the box. It's very hard to watch a bear market correct to the upside while you're on the sidelines in bonds or notes or money market funds.

It's hard because there's a lot of greed in the land, and you're hearing all sorts of stories and rumors about how much this guy or that lady is making. Of course, you hear little or nothing about how much these same people have lost.

A bear market requires patience, a lot of it. You're in the game of "resisting the tempting purr of the bear." The bear wants you in the market. He can't take your money if you're in T-bills or money market funds or short notes. But he keeps on purring, and he'll continue to purr until the market breathes its last.

NOTES & QUOTES: I have the smartest subscribers in the letter-writing business (I'm convinced of this) with many of my subscribers being Wall Streeters or managers of mutual funds or pension funds and others being professional traders.

This from an e-mail received two weeks ago: "What are the bonds saying now? Well, with the two-year note down near 4.5% and Fed funds at 6% (just recently, of course, having dropped to that), we bond men are clearly telegraphing a FULL 200 basis point short rate drop during 2001. And that assumes no further bond rally, which looks like a really bad bet given the freight train trend now in place.

"Obviously, this rate slashing need is consistent only with a DEEEEEP recession, and you are quite right to point out that the stock market is wholly unlikely to find any traction with these rate cuts until we are far along in this process.

"You haven't put it this way yet (and I quote you, in the mirror, so-to-speak, from some 15 years ago): 'It's a great bear market; get with it or get out of the way.'"

Here's another e-mail; "Russell, you may wish to comment generally to your readers. Your PTI has been bullish for over a month, since December 11. You have commented several times over that period how 'smart' the PTI is, despite your personal bearish (for the moment) bias.

However, over the same time period the S&P is DOWN over 6%. Maybe you are the smart one, and the PTI is clueless."

My answer: I've stated that I place top emphasis on the primary trend of the market. When the PTI is bullish in the face of a primary bear market, I step aside, I buy no stocks, I treat the bear market as the overriding consideration as far as my market position. The PTI has been bullish since Dec. 11, and that's a plus for the market in that the breadth and most stocks have advanced. But it's a bear market, and regardless of what the PTI does, I'm on the sidelines.

When the next bull market begins, I'll be fully invested anytime the PTI is above its moving average. Until then - be safe and respect the bear.

Here's another: "Hi Mr. Russell: In 1948, over 90% of people surveyed (by the Federal Reserve Board) were opposed to owning common stocks. Today we'd probably find 90% in the other direction. People don't realize, as you say, how the tide can turn (reference B. Graham, 'The Intelligent Investor.' What he says about speculators vs. investors rings as true as if it were writtten today."

The following is from Lester Thurow's piece in the Jan. 18 *USA Today*: Thurow believes that Clinton has been amazingly lucky regarding economics in his reign. Bush, he believes, will inherit the problems. "But recession is not the worst term Bush could hear. If Bush is really unlucky, he will learn firsthand about managing an international crisis in which America is directly involved.

"'Flight from the dollar' will be the unlucky words. For two decades America has done something that just cannot be done forever -- run a large trade deficit that must be financed by foreign inflow of funds. As foreign funds flow in, the funds that must be borrowed grow ever bigger. Interest and dividends must be paid on the larger and larger foreign investments in America.

"It is absolutely certain that at some point the world simply will not want to invest the requisite funds that are necessary if America is to run large trade deficits, now in the neighborhood of $450 billion per year. The necessary inflow of funds has gone on for 20 years and could go on for another four, but with growth slowing and the stock market falling, investing in America looks a lot worse today than it did a year ago."

* *

Unlike the US, China has a glut of electricity and the price of electricity is falling as well. In the face of this, China is building the enormous Three Gorge Dam. It's an incredible effort, qualifying as one of the biggest construction projects in world history. It will be the largest hydroelectric dam in the world, five times wider than the huge Hoover Dam. It will take 26 million tons of concrete to build. It will have an estimated capacity of 18.2 million kilowatts, and will supply 11% of China's electric needs. As of July, 248,000 people who lived on the banks of the Yantze have been resettled. Behind the dam a vast reservoir, 50 miles longer than Lake Michigan and 580 feet deep, will submerge two cities, 11 county seats and 114 towns.

* *

What's behind the huge swings in the market? A Texas Christian Univ. study indicates that mutual funds, not day-traders, are responsible for the big moves. The study shows that a large portion of the funds' buys and sells come at the first half hour or in the last half hour of trading.

* *

I love words. English contains words from at least 35 foreign languages. Webster's Collegiate Dictionary contains 90,000 "head words" or words that are heavily outlined with many other uses below them. For instance, under the headword "wild" you will find "wildness," "wild wind," "wild cherry," etc. In a larger dictionary, such as the Oxford English Dictionary, there are 250,000 words (I have this unabridged dictionary and it's in about 20 volumes and it takes up two large shelves.

How many languages are there? One estimate is that there are 6,703 separate languages. English is very flexible. Each year it is estimated that 3,000 to 5,000 words are added to English. English is arguably the most important language because it is used widely in scientific and technical writing. Businesses around the world depend on English. How many words does the average person use? Maybe a few thousand up to five thousand.

* *

Legislators and governors returning to America's statehouses are facing the most sobering news in the last five years - shrinking revenues. For the first time since 1995 the forecasts are for lower state tax income from all sources - individuals, corporations and sales, setting off a domino effect as officials try to make up their budgets for 2001. The problem -the slowing US economy and rising healthcare costs.

* *

Japan, the world's second largest economy, continues to have troubles. A few weeks ago the head of the Bank of Japan stated that "we need to pay close attention to risks that the Japanese economy may worsen and deflation fears may re-emerge due to external shocks."

BoJ chief warns of deflation

By David Ibison in Tokyo

The Bank of Japan's decision to end its decade-long zero interest rate policy was increasingly looking premature yesterday after its governor Masaru Hayami said the prospect of deflation was back on the horizon.

Mr Hayami told business leaders that "seeing as the pace of recovery is gradual, we need to pay close attention to

Trade and Industry all industries index, which measures supply side economic activity, came in unchanged for October, compared with a forecast 0.8 per cent rise.

The figure followed a 1.6 per cent decline in September and led economists to believe that Japan's fourth quarter economic performance could end up in negative territory.

* *

What were the best-acting stocks of 2000? Philip Morris up 89%, Boeing up 58%, Merck up 39%, JP Morgan up 30%. What were the worst? Home Depot down 33%, Eastman Kodak down 40%, Microsoft down 62%, AT&T down 66%.

* *

How much does the US depend on cash from our foreign friends? In the first nine months of 2000 foreigners poured in $ 682 billion. This created a record US trade deficit. The danger - slower growth in the US may make foreigners look elsewhere, in which case the dollar will be in increasing trouble.

* *

The "Four Horsemen" of tech on the Nasdaq are or were Microsoft, Dell, Intel and Cisco. Two years ago these four combined equaled 30% of the total value of the Nasdaq's $2.3 trillion value. Now the four represent about 22% of the Nasdaq's $4.4 trillion value. Some say the four horsemen rose to power on the back of the personal computer. They add that the power of the personal computer has passed. In fact, sales of hand-helds and cell phones are expected to pass personal computers in a few years.

* *

On taxes, Russia is way ahead of the US. A week ago Russia slashed its income tax to a FLAT rate of 13% for everybody. This makes the Russians the least taxed people of any major nation. You have to wonder when US politicians will have the brains to bring in a flat tax of maybe 18% for ALL Americans.

Sweeping Reforms in Russia Cut Income Tax to Flat 13%

Agence France-Presse

MOSCOW — The most far-reaching Russian fiscal reforms in 10 years entered force Monday, slashing the income tax to a flat rate of 13 percent, putting Russians among the world's least taxed people, Moscow Echo radio reported.

The Russian Parliament voted overwhelmingly on July 26 to adopt the new legislation, simplifying tax procedures and reducing personal tax in a bid to increase Russia's chronically low revenues.

"It's an important event in the life of the country," President Vladimir Putin said when signing the decree making the measures law.

the early 1990s. The reforms aim to reduce fraud and encourage businesses to invest in the national economy.

Chronically poor tax collection has helped cripple the Russian government's finances for the past decade.

With taxes too high, too numerous and too complicated, they have been a standing invitation to both individuals and businesses to doctor their annual revenue declarations.

The government's calculates that lower taxes will generate more revenues by increasing compliance.

Russia's richest citizens — those who declare income of more than 150,000 rubles ($5,260) a year — have until now

* *

I've said, and I maintain, that this century will be "The Century of the Woman." It all starts with education and the vote. There are now more women in universities in the US than men. More women are receiving advanced degrees than men. Like her or not, Senator Hillary Clinton is sitting on three Senate committees. As for Washington, five women will be on the Senate Appropriations Committee, four on Commerce and two on Finance. That's more than double the number on those committees five years ago.

Worldwide, I expect a huge advance in the rights and the power of women. It's going to happen via communication, TV, the Internet, publishing.

I can see the difference with my wife, Faye, who's a top corporate lawyer. Ten years ago when she started with Brobeck, Phleger and Harrison I asked her, "Aren't you afraid that you'll find a lot of companies and their tough CEOs prejudiced against dealing with a woman corporate lawyer?" Her answer, "I'll find out." She did find out. There's no prejudice. Corporations are interested in only one thing - "Your brains. How good are you?" Faye is very good. She's found no prejudice.

* *

The credit ratings of US corporations fell sharply in the 2000. Credit ratings of a record 470 corporations with $858 billion of bonds were downgraded, according to Moody's. Global rate of default of high-yield (junk) bonds rose to 6% in 2000, from 5.1% in 1999. Moody's forecasts a 9.1% rate for 2001. That's almost one out of ten.

The market in municipal bonds is huge, one of the largest in the world. Roughly $1.3 trillion in muni bonds are held by investors - more than 50,000 state and local entities have issued muni bonds, with 1.5 million different issues outstanding (it would take 90 pages of your local newspaper to list them all). Daily trading volume is estimated at $7 billion. Some bonds are actively traded and some are only traded months at a time. Most individual investors hold their bonds until maturity.

Muni bonds are traded in the over-the-counter market rather than on any organized exchange. About 2,700 banks and brokerage firms are registered with the Municipal Securities Rulemaking Board in Washington DC to buy and sell munis. Muni bonds are priced based on credit quality, maturity, liquidity and yield. Each bond dealer prices the bonds at a yield which takes into consideration all the various factors.

CYCLES: My old friend Bob Powers is a brilliant securities analyst and a tireless worker. He was using computers before most people knew what the word meant.

Last week I received a most interesting e-mail from Robert. Here's what he writes. "Since 1802 the real (inflation adjusted) total return in the US stock market has averaged 7.08% a year. If one looks at annual data, there have been seven 'strong cycles' since 1802, where the median annual real total return has been 14.0%, and seven 'weak cycles' where the median annual total return has been 0.0%. The strong cycles have lasted 17 years on average, while the weak cycles have averaged 16 years. From 1982 to 1999, we have experienced a 'strong cycle', with the average annual total return for that time period being 14.9%.

"The table below depicts these strong and weak cycles, showing the time periods, real annual total returns, and duration."

Russell Comment: This is outstanding and extremely important research. According to Powers' research, we are now moving into a weak cycle. This corresponds with the high price/earnings ratio for the S&P which is now 25. When the P/E for the S&P is above 22, the median annual return for the stock market runs 5.0%.

```
Weak Cycles-----------
1802-15 +2.7% 13 years
1835-43 -0.6% 08 years
1853-61 -3.0% 08 years
1881-97 +3.9% 16 years
1902-21 +0.0% 19 years
1929-49 +0.8% 20 years
1966-82 -1.4% 16 years

-Strong Cycles-------
1815-35 +10.0% 20 years
1843-53 +13.7% 10 years
1861-81 +12.0% 20 years
1897-02 +15.2% 05 years
1921-29 +25.2% 08 years
1949-66 +14.0% 17 years
1982-99 +14.9% 17 years
```

LATE NOTES: I think what is happening now is that fund managers believe that the Fed has already put in a bottom to the economic contraction via a booming money supply and declining Fed Fund rates. Therefore, the managers are LOOKING PAST ANY AND ALL BAD NEWS and buying stocks based on the expected upturn which they are convinced lies ahead. And it's on that basis that they are buying stocks.

The "bond inflation barometer" is starting to show signs of inflation. The yield on the 10 year T-note minus the yield on the TIPS (inflation adjusted 10 year T-note) is now 1.70, up from a recent 1.45. Thus the bond market is "saying" that the Fed's massive creation of new money ($160 billion in six weeks) may be stirring up inflation. If so, we might be facing that old bugaboo – STAGFLATION.

Gold just can't get going. On Friday, Jan. 26, the Feb gold contract broke to 263.50, a discouraging new low for gold – this in the face of booming platinum and palladium. Every start this year has turned out to be a false start. The same is true for silver. It seems that gold will languish until such time as faith in the dollar collapses. But so far, despite the US's chronic negative trade balance, the dollar holds up. "The market always does what it's supposed to – but never when."

Many people mistake a good rally in a bear market as the first sign of a new bull market. That happened at the 1929 crash low. During November 1929 to April 1930 the Dow recovered 52% of its crash losses in an upward correction that turned almost everyone bullish again and proclaiming that "It's a new bull market." As we now know, it wasn't a new bull market at all.

To take it to the present, we're now hearing various experts claim that the bear market is over and that a new bull market has begun. One robin doesn't make a spring, and an initial rally in a bear market doesn't mean a new bull market. In fact, the S&P now sells for 25 times earnings while yielding just over 1%. No bull market ever started with exorbitant values like these.

It's well to remember (but often ignored or forgotten) that corrections in both bull and bear markets usually regain one-third to two-thirds of the previous major move. The Nasdaq has now regained about 22% of its March to December losses while the S&P has regained about 38% of its March to December losses. Both are very typical but unimpressive bear market corrections, and the corrections might not be over yet.

The California power mess will end in due time. California has a "not in my back yard" attitude as far as building new generators. So what's next? Very possibly generators in Mexico. But one thing is sure – electric and gas bills are going to go UP in California, it's just a question of "how much?" San Diego Gas & Electric is already asking for a 17% rate increase. The power miasma makes California a much less inviting place for business.

CHART BOOKS AND CHART PAGES 2000. Don't ask me why but in an industry that involves trillions of dollars, nobody else does this. What I'm talking about is chart books of the **D-J Averages** and the all-important **breadth index** (i.e. advance-decline ratio). I've been offering these two chart albums for decades, and I feel they're invaluable. Actually, I started these albums back in the '60s because I needed the data myself. The first volume is a **complete daily history** of the D-J Averages (all three Averages plus bonds and volume) going back to **1885**. Important economic and world events are notated on each page. The charts are packed in a big three-ring, hard-cover binder, one page for each year. The album is yours for $140; we pay the postage in the States.

The second album covers the Dow and the extremely important A-D ratio (daily) going back to 1931. Comments regarding the action are included in many of the pages (one page for each year). The price is $100, we pay US postage.

For those who own the chart books, the new 2000 pages are ready, and the price is $5 for the page of the Averages and $5 for the new A-D ratio page. Please send your money in now (outside the States there's an extra postage charge of $35 for each album). Write to Dow Theory Letters, PO Box 1759, La Jolla CA 92038.

NEXT MAILING: February 21, 2001